

As Time Goes By...

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I recently celebrated my 30th anniversary of the start of my career in the investment business, and in October we are celebrating the 25th anniversary of Clover's inception. Back in July of 1979, 24 years old and nearly clueless about the markets, I reported to my boss, Geoff Rosenberger, and spent my first weeks at work reconciling custodian statements for client accounts. Eventually I was immersed in the investment research effort, continually trying to understand the world around me and translate that understanding into investment decisions. Thirty years later, I'm doing the same thing. Fortunately, I find the work endlessly fascinating and, while frequently stressful, still very rewarding.

With the passage of the 30-year mark, I've taken some time to reflect back on the prevailing conditions back in 1979 and at each decade forward – 1989, 1999 and today. I find these memories entertaining and instructive; perhaps we can draw on the past to develop some perspective on the future.

1979 – Malaise, Inflation and the Death of Equities

Pessimism reigned as we approached the end of the decade of the 1970s. Following Vietnam, Watergate, oil shortages, pervasive inflation, rising interest rates and a weak economy, there seemed to be little reason for optimism. In the investment markets, the devastating bear market of 1973-1974 scared many individuals and institutions out of equities. BusinessWeek ran its famous cover story, "The Death of Equities," on August 13, 1979. The average P/E multiple fluctuated between 8 and 10, but critics argued that stocks were not cheap because earnings were dramatically overstated by inflationary effects on inventories and depreciation. Also, a risk-free rate (Treasuries) approaching 10% demanded a lower P/E for stocks. Commodity prices, led by oil and gold, raced higher. We had arrived at "stagflation": a condition of slack economic progress, high unemployment and systemic inflation. Jimmy Carter gave his famous fireside chat, telling us that the country was gripped by "malaise" and suggested we turn down the thermostat and wear sweaters to deal with rising energy bills. There were forecasts that the world would see an increasingly short supply of oil in years to come, devastating developed economies. Rising interest rates cut bond prices down. Eventually, Treasury bonds were labeled "Certificates of Confiscation" because the double-digit inflation would destroy the purchasing power of your money by the time the bonds matured. Gold, oil stocks and T-bills were the preferred investments of the day. With the Islamic revolution toppling Iran and threatening others, the USSR firmly entrenched as an antagonistic superpower and the U.S. military stuck in post-Vietnam shambles, our future prospects and world status seemed dubious.

Not a great environment to launch a career! My father thought I was crazy to take that job versus another offer that I had with a big, safe company in the pharmaceutical industry, but I decided to give stock picking a try. The stock and bond markets were moribund at the time, but just three years later, the next secular bull market emerged from the gloom.

1989 – Bull Markets, Junk Bonds and Japan

Despite a wicked scare in the crash of October 1987, the stock market registered a healthy double-digit gain in the first decade of my career. The economy showed reasonable growth, inflation fell, interest rates trended lower and stock valuations went higher. However, critics pointed out that the rising valuations added too much risk to stock investments and that financial engineering and leveraged buyouts were inducing near term gains but would foster long term risks. In 1989, the firm that championed the junk bond and pioneered the leveraged buyout, Drexel Burnham Lambert, was about to collapse and the Savings & Loan industry (big buyers of junk bonds) would quickly follow as the risks of high leverage became apparent. The Federal Government was forced to step in and stabilize the financial industry via the Resolution Trust Company. On the global stage, big changes were in progress as the Soviet Union dissolved and Japan was the most successful economic player. Japan's stock market reached astounding heights in 1989, with valuations that were crazy by any statistical standard. Sony chairman Akio Morita and Tokyo governor Shintaro Ishihara co-authored a book, *The Japan That Can Say No*, which touted the Japanese economic model and culture as superior to that of other countries, particularly the United States. The Japanese export success brought them huge U.S. dollar balances, which they used to buy U.S. Treasuries, real estate and corporate assets.

1999 – Tech Boom, Greenspan and Market Mania

Following the real estate and junk bond bust of 1990-1991, the stock market resumed its upward trend in my second decade. The economy stayed on a steady track with Federal Reserve Chairman Alan Greenspan at the helm of monetary policy. Some wondered whether we had repealed the economic cycle and credited Greenspan's deft maneuvers with a new, stable reality for the previously cyclical meanderings of GDP. Emerging markets boomed in the mid-1990s, then busted in 1998. Japan's bubble burst, and the country entered a long period of economic weakness that saw its real estate and stock markets slump. The British rule of Hong Kong ended in 1999 and there was much trepidation about how the Chinese would handle this vibrant hub of the Asian economy.

Dominating the economic landscape in the last half of the decade was the much feared "Y2K," the turn of the century which was predicted to cause much mischief with our computer-dependent society. These fears precipitated an enormous wave of capital spending on technology, software and related services as businesses, banks and governments brought in Y2K-compliant technology before the clock turned. This coupled with the emergence of the internet to catapult "all things tech" to the forefront of economic development. Stock market investors came along for the ride, boosting equity returns to over 20% each year for a record five years in a row (1995-1999). Silicon Valley, Route 128 and most points in between embraced the "Equity Culture," as new technology startups were funded with ease and every employee wanted stock options as part of their compensation package. Venture capitalists were the elite players of the tech boom.

While technology propelled the stock market and economy forward, much of the "Old Economy" faltered in the last two years of the decade. The collapse of emerging Asian economies, Russia's default on its debts and the financial crisis stemming from the implosion of the huge hedge fund, Long Term Capital Management (LTCM), all hit in the summer of 1998. Commodity prices collapsed – oil tumbled below \$11 per barrel. The U.S. Government orchestrated a rescue of LTCM to prevent the spread of financial contagion to counterparties such as Lehman Brothers (sound familiar?). From mid-1998, the "Old Economy" was derailed, but the "New Economy" stayed on its meteoric growth track.

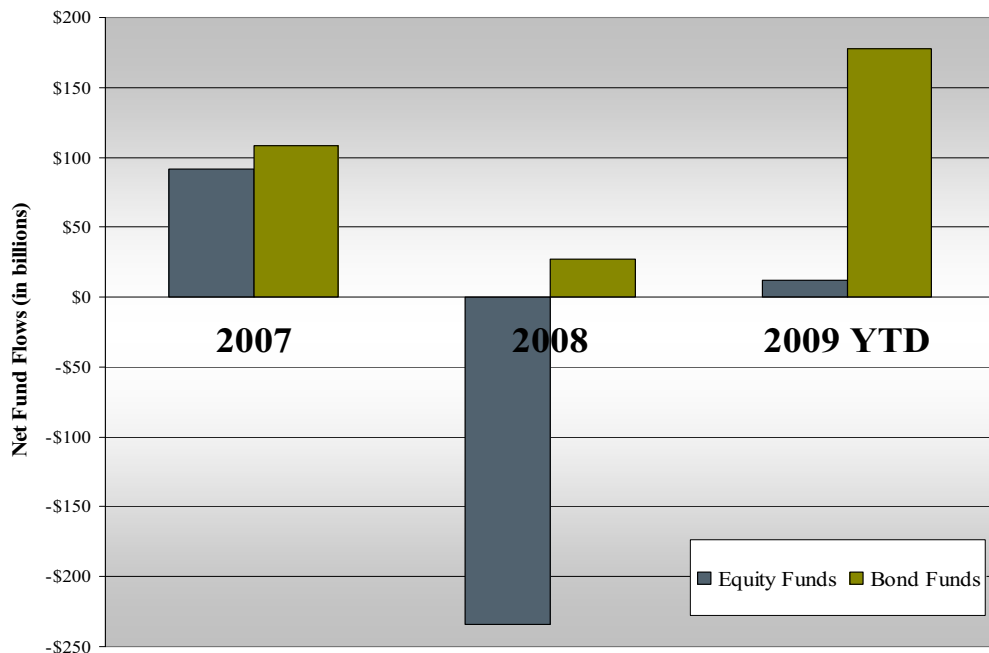
The period of 1998 to 2000 was by far my worst career experience. The stock market rose to new records, fueled by nonsensical values for tech stocks. Value investing was declared dead; the quaint, old-fashioned notion that stock holder returns were linked to a company's revenue, assets and cash flow was obsolete in the "New Economy." Our refusal to join the party in the tech mania cost us many clients and innumerable sleepless nights. Our cheap stocks got cheaper and the expensive stocks continued to rise. We were repeatedly told, "it's different this time" and stodgy old value investors "just don't get it." It was a classic bubble, a scenario that has played out many times in the past. Fortunately for us, by late 2000, the bubble burst and fundamental investment efforts began to matter once again. However, massive damage was done to investors in the aftermath of the bubble and the period marked the end of the secular bull market.

2009 – Fear, Panic and the Frugal Future

What a difference a decade makes! While the stock market enjoyed a modest cyclical recovery from the recession lows of 2002, the hot action in the 2003-2007 economic upturn was in the residential real estate market. Spurred by easy mortgage

loan terms and lax underwriting standards, home prices soared. Speculative activity in development and construction blossomed as builders sought to capitalize on the seemingly insatiable demand for housing. A significant portion of the demand came from investors, as “condo flipping” took the place of internet stocks in this manic bubble. As we saw following the 1989-1991 commercial real estate peak, real estate busts are especially devastating because of the use of leverage (mortgage debt). When prices plummet, many homeowners are wiped out and mortgage lenders (banks) also take losses. Since mortgage lenders tend to be thinly capitalized themselves, the entire financial system is thrown into chaos and the collateral damage spreads to the world economy. As in 1990 and 1998, the Government has had to step in to control the panic and restore a functioning financial system.

Chart 1: Net Investments in Equity vs. Bond Mutual Funds



Source: Investment Company Institute, data as of 7/31/09.

for stocks in 1999 has now reversed and many investors have fled equities and piled into cash or low risk bonds. Even the sharp rally off the March lows has failed to entice much of the cash mountain back into stocks. Bond funds are seeing sizeable inflows, but stocks are still out of fashion (Chart 1).

While the nasty 2007-2009 recession appears to be abating, the consensus view of the future calls for a “New Normal” of sub par economic growth in the U.S. This view, popularized by Bill Gross and Mohamed El-Erian at PIMCO, is based on the need for U.S. consumers to cut back on consumption and increase savings for an extended period, repaying the excesses of credit card and mortgage debt of past decades. At the same time, the emerging markets of Asia are expected to continue high growth rates as their economies transition from export-focused to internally-driven consumption. Raw material and energy suppliers in Australia, Canada, Africa and South America are expected to flourish by exporting into the rapidly growing Chinese-Asian demand.

In many ways, it seems that the investment and economic environment have come full circle in my 30-year career. The malaise and pessimism have returned, following an extended period of poor economic conditions and investment returns. The major difference is that in 1979, the crowd was chasing inflation hedges, while in 2009, the crowd wants “no risk.” While there is a lot of talk about future inflation today, money market funds, CDs and Treasury bonds are the investments of choice for today’s crowd.

I recently attended a forum for endowment investors where one participant noted that poor liquidity and unpredictable returns make venture capital partnership investments a poor choice for endowment portfolios. In 1999, he would have been laughed out of the room. In 2009, no one disagreed. This is testament to the powerful allure of liquidity and “no risk” for investors as they look at 2008 in the rear view mirror.

Surprise, Surprise...

Who would have predicted in 1979...

- That oil and gold prices would be substantially lower 20 years into the future?
- That the USSR would not exist 10 years later and the U.S. would be the lone superpower?
- That 10-year U.S. Treasury Bonds would yield 2% in 2008 (down from double-digit yields)?

Who would have predicted in 1989...

- That Japan was about to embark on 20 years of stagnant economic activity and a declining stock market?
- That newspapers and television networks would be sliding into oblivion in 20 years?
- That over 1000 banks would vanish in the Savings & Loan Crisis?

Who would have predicted in 1999...

- That tech stocks would be among the worst investments of the next 10 years?
- That cash would be better investment than equities over the next 10 years?
- That venture capital would be deemed “inappropriate” for endowment investment in 2009?
- That the U.S. would spend 8 of the next 10 years at war?

2019 – What Lies Ahead?

This brief look back at my ten-year milestones highlights the twists and turns that grip economic and investment events. In most cases, consensus expectations develop only after a trend has been in place for a while – often just as the trend is about to be unexpectedly altered. Indeed, it is the unexpected that drives future investment returns, precisely because of the surprise factor. What the consensus expects is already reflected in asset prices; those prices change as we adjust to the unexpected future – both good and bad.

So what will we experience in the next decade? Probably some of what the consensus expects, along with a lot that is unexpected. My crystal ball is as cloudy as always. Fortunately, we utilize value investing and a fundamental framework, which is the best way to prepare for the unexpected and avoid being swept away by emotions (see “Investment Strategy: Why Value Works” [April 2002] and “Risk and Return: 2008 Update” [October 2008] on Clover’s website). The one thing I will predict is a continuation of the patterns of human behavior that bring us cycles of economic and investment experience – the ups and downs, the booms and busts that have been with us throughout history. With my colleagues, I look forward to pursuing the investment opportunities presented by these cycles. Stay tuned for the update in 2019.

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